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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

No. 1078

EDWIN J. HERPICH, on Behalf of All the Stockholders of National American Life Insurance Company,
Petitioner,

vs.

ROBERT E. WILDER and NATIONAL AMERICAN LIFE INSURANCE COMPANY, a Louisiana Corporation,
Respondents.

SUPPLEMENTAL BRIEF FOR PETITIONER IN SUPPORT OF HIS PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Pursuant to Rule 24 of the Supreme Court Rules, this Supplemental Brief for Petitioner is respectfully filed to call to the Court's attention an *amicus curiae* brief (reproduced hereinafter as an appendix hereto) filed by the United States Securities & Exchange Commission in January, 1971 in **Levine v. Seilon, Inc.**, now pending in the Second Circuit.

In the appended *amicus* brief, the SEC has argued forcefully that the "purchaser-seller" limitation on civil actions brought for violations of Rule 10b-5 is inconsistent with the purpose of the 1934 Act and denies relief to persons within the class Congress intended to protect. This construction of the 1934 Act by the administrative agency charged with enforcement of the 1934 Act is believed to be of great relevance to the issues presented to this Court in our petition for certiorari in Case No. 1078 now under submission.

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APPENDIX

TEXT

SEC AMICUS BRIEF ON LEVINE V. SEILON, INC. (CA. 2, ARGUED 1/13/71)

The Securities and Exchange Commission ("Commission") submits this brief, amicus curiae, pursuant to leave of this Court granted by order dated December 24, 1970, on whether the complaint states any claim for relief under Sections 14(e) or 10(b) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78n(e) and 78j(b), and Rule 10b-5, 17 CFR 240.10b-5 promulgated thereunder.

STATEMENT OF THE CASE

Irving Levine, a former preferred shareholder of Seilon, Inc., brought this action for damages under Sections 14(e) and 10(b) of the Securities Exchange Act of 1934 ("the Act") and Rule 10b-5 thereunder, alleging that the defendant, Seilon, Inc. ("Seilon"), a New York Stock Exchange listed company, perpetrated a scheme to defraud its preferred shareholders. The action was brought by the plaintiff on his own behalf and on behalf of all other former owners of preferred stock of Seilon similarly situated (22a)[1] The amended complaint[2] in essence alleges the following:

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[1] "a" refers to the appendix to appellant's brief.

[2] The amended complaint repeats in a greater detail the allegations of the original complaint and is assumed in this brief to be the basis upon which plaintiff has stated a claim under both Sections 14(e) and 10(b). The Commission recognizes that defendant-appellee views the pleadings somewhat differently, Brief of Appellee pp. 3-8 and 32, although it apparently recognizes (p. 6) that "both complaints make basically the same assertions."

Seilon desired to create new funded debt to proceed with a program of corporate acquisitions (27a) but such new debt required the prior approval of two thirds of Seilon's preferred shareholders (24a 25a).

In order to obtain this authorization, on June 6, 1968, Seilon told its preferred holders that it would give them six and one half shares of Seilon's common stock for each of their preferred shares (27a 28a). Since the preferred stock was held subject to a call for redemption (24a), Seilon also assured its preferred holders that it would not redeem any of their shares until after the intended exchange offer had terminated (27a).[3] In fact, when Seilon made these public announcements, it secretly intended and planned to redeem the preferred shares without offering any exchange of common stock (27a 28a).

Seilon's scheme entailed twin courses of action. At the same time it engaged in delaying tactics and further misrepresentations with respect to its announced exchange offer, it proceeded to enter into a series of financial transactions designed to raise, if possible, the necessary cash to redeem (29a 30a).[4] The company knew that the So-

[3] The announced ratio of common stock for preferred would have been worth substantially more than the redemption price and was intended to and did artificially inflate the market prices of preferred shares (28a; 35a).

[4] It is fundamental that on a motion to dismiss, the complaint must be construed most favorable toward the plaintiff, **see A. T. Brod & Co. v. Perlow**, 375 F.2d 393, 397 (C.A. 2, 1967). Although the complaint is far from a model of clarity, nevertheless, so construed, it implies that Seilon intended to redeem the preferred shares because this would have obviated the need to offer a more expensive exchange of common stock to obtain the preferred holders' requisite approval of new funded debt. It further appears that Seilon continued its delaying tactics and misrepresentations with respect to the exchange offer in order to, on the one hand, provide the company time to raise the money for a redemption and on the other, to, if necessary, proceed with the common stock exchange if it turned out that in

curities Act of 1933 exempted the common stock in the exchange offer from this Act's registration requirements (28a). Nevertheless, Seilon told its preferred shareholders on June 6, 1968 that such a registration was required to effect the exchange (27a). After a willful delay of three months, on September 10, 1968, the company filed a fraudulent registration statement to cover the common stock to be exchanged for preferred (30a). This registration statement reaffirmed that Seilon would begin its exchange offer "as soon as practicable" and that the company did not intend to redeem any preferred shares until such offer terminated (31a). Following the bogus filing, the company began to solicit the preferred holders to accept said exchange offer (31a).

While it engaged in the fraudulent activities described above, Seilon was also proceeding in accordance with its scheme to try to raise sufficient money to redeem the preferred shares without offering any exchange. There were certain stock holdings which Seilon had pledged to a bank as collateral for notes payable. In June 1968 the company sold these investments and deposited instead the cash proceeds as collateral. Seilon then formed in June a new corporation, Lockwood, Inc., and exchanged the assets of one of Seilon's operating divisions for 1,000,000 Lockwood shares (29a 30a). On September 27, 1968 Lockwood filed with the Commission a Form S-1 Registration Statement for the public sale and issuance of its common stock (32a). On the basis of this proposed public offering[5] Seilon

fact Seilon could not finance the necessary cost of a redemption. No doubt the complaint leaves several questions unanswered. These questions, however, do not appear sufficiently significant to warrant dismissal. **Cf. Schoenbaum v. Firstbrook**, 405 F.2d 215, 218 **(en banc** —C.A. 2, 1968), **certiorari denied sub. nom., Manley v. Schoenbaum**, 395 U.S. 906 (1969).

[5] Before becoming effective, such a public offering would also have had to have had the approval of the preferred shareholders (30a).

managed sometime after October 1968 to raise the cash necessary to redeem. In accordance with its scheme, it substituted as collateral the Lockwood shares to be offered publicly for the cash collateral deposited earlier in the bank. With the funds thus released, Seilon announced a redemption of all preferred shares on December 10, 1968 (32a).[6] The rights of the preferred shareholders were thereafter terminated and their shares involuntarily converted into a claim for the cash amount of the redemption price (33a-34a).[7]

Seilon's scheme, which successfully opened the way for the creation of new funded debt, had the intent and effect of: (1) artificially inflating the market price of the preferred shares; (2) misleading the preferred shareholders into retaining their holdings when they could have sold them on the market at a higher price, (3) misleading the public into buying preferred shares and inducing the preferred shareholders to consent to new credit arrangements which they had previously refused to approve (28a-29a; 35a).[8]

The preferred shareholders, in furtherance of the fraud perpetrated by Seilon, were forced to accept the redemption price. But for the fraud which culminated in the redemption of the preferred shares, the plaintiff alleges he

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[6] In this manner Seilon avoided the higher costs of having to make the exchange offer to obtain the preferred shareholders' approval of new funded debt. **See infra** note 7.

[7] The public files of the Commission (No. 2-30091-1) reveal that on January 9, 1969, Seilon withdrew the registration statement covering the proposed exchange offer. In a letter to the Commission dated January 7, 1969, Seilon justified the withdrawal by stating that the exchange offer would have cost the company nearly two million dollars more than the cost of a redemption.

[8] The complaint does not say if these new credit arrangements were related to the means by which Seilon obtained the necessary cash to redeem.

would have accepted the Exchange Offer (35a). On behalf of all former owners of preferred stock similarly situated, plaintiff claims as damages the difference between the redemption price and the value of the common stock package which Seilon fraudulently assured the public it would offer in exchange for its preferred shares (22a; 36a).

On Seilon's motion, the court below dismissed the original and amended complaints and held that: (1) Section 14(e) of the Act did not apply because "no tender offer was made in this case" and Section 14(e) "appear[s] to have been intended to prevent misrepresentations with respect to tender offers or invitations for tenders that are actually made" (19a) and (2) that no claim had been stated under Section 10(b) and Rule 10b-5 thereunder because the delivery of preferred stock for redemption was not a "sale" and alternatively, even if the redemption were a "sale," the alleged fraud was not "in connection with" the redemption (42a; 43a).

ARGUMENT

I. The Complaint States a Claim for Relief in Favor of Plaintiff Under Section 14(e)

It is the Commission's contention that the anti-fraud provision of the 1968 tender offer amendments to the Act, Section 14(e), does not require that the fraud be in connection with tender offers, requests or invitations for tenders that are "actually made" as distinguished from those which have not yet commenced. This section prohibits fraud or misstatements "in connection with **any** tender offer, request or invitation for tenders or any solicitation . . . in opposition to or in favor of any such offer. . . ." Section 14(e) is intended to affirm that anyone "seeking to influence the decision of investors **or** the outcome of [a] tender offer" (emphasis added) has a duty

to disclose all material information to those with whom he deals.[9] The purpose of Section 14(e) is to help maintain an honest securities market by ensuring that public investors have truthful information to make investment decisions when a tender offer could affect that decision.[10] Since the market may be manipulated by a fraudulent announcement of an intent to make a tender offer as well as by deception in the tender offer itself, the Commission urges that Section 14(e) be construed to give effect to its broad antifraud purpose.[11] The terms of Section 14(e) are deliberately inclusive. In the Commission's view, fraud in the announcement of intent to make a tender offer is, under the terms of the section, "in connection with any tender offer."[12]

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[9] Both the House and Senate Reports on the Williams Act (House Report No. 1711, 90th Cong., 2nd Sess. p. 11; Senate Report No. 550, 90th Cong., 1st Sess. pp. 10-11) state:

> "Proposed subsection (e) would prohibit any misstatement or omission of a material fact, or any fraudulent or manipulative acts or practices, in connection with **any** tender offer, whether for cash, securities or other consideration, or in connection with any solicitation of security holders in opposition to or in favor of **any** tender offer. This provision would affirm the fact that persons engaged in making or opposing tenders **or otherwise seeking to influence the decision of investors or the outcome of the tender offer** are under an obligation to make full disclosure of material information to those with whom they deal" (emphasis added).

[10] Such a construction of Section 14(e) supplements the intent of the Securities Exchange Act of 1934 which was enacted "to insure the maintenance of fair and honest markets" for securities. Section 2, 15 U.S.C. 78b.

[11] ". . . remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation." **Tcherepnin v. Knight**, 389 U.S. 332, 336 (1967).

[12] This view is consistent with Congress also prohibiting in Section 14(e) fraudulent conduct "in connection with . . . **any solicitation** "relating to a tender offer. That term has been broadly defined under Section 14(a) of the Act and has been

The district court's interpretation of Section 14(e) is fundamentally inconsistent with other provisions of the Williams Act. Section 13(d)(1) prevents **potential** tender offerors from acquiring, by open market or private purchases, too large a block of stock in a company before such persons' identity and **intentions** are made known to the public and management. Since Congress obviously **believed that the disclosure** of intentions under certain situations was necessary for the protection of investors, it would be contradictory, if not self-defeating, to construe the antifraud provision of the legislation as not applying to fraudulent misstatements of a person's intent to make a tender offer when such disclosure is required by Section 13(d) itself.

If, after a person's acquisition of beneficial ownership of any equity security of a publicly held company, he beneficially owns more than 10 percent of the securities of that class, Section 13(d) requires him to file a statement

so interpreted by this Court, **Studebaker Corp. v. Gittlin**, 360 F.2d 692 (1966). The similarities between the proxy rules and the tender offer legislation has also been recognized by this Court, **Electronic Specialty Co. v. International Controls Corp.**, 409 F. 2d 937, 1,948 (1969). As this Court stated in **Studebaker** in referring to **Securities and Exchange Commission v. Okin**, 132 F.2d 784 (1943), it had long been recognized that "a letter which did not request the giving of any authorization was subject to the Proxy Rules if it was part of 'a continuous plan' intended to end in solicitation and to prepare the way for success." **Studebaker, supra,** 360 F.2d at 696. To hold otherwise would mean, as Judge L. Hand said in **Okin**, that "one need only spread the misinformation adequately before beginning to solicit, and the Commission would be powerless to protect shareholders." 132 F. 2d at 786. There is nothing in the legislative history of the tender offer amendments to suggest that Congress intended the term "solicitation" to be more narrowly construed here than it had been in the proxy area. Indeed, the Commission has recognized that the need for protection of the stockholder "may be greater in the case of the tender offer than in a proxy dispute." **In the matter of Reports of the Susquehanna Corp.** Securities Exchange Act Release No. 8933 (July 17, 1970) CCH Fed. Sec. L. Rep. par. 77, 842 at p. 83,987.

of information (Schedule 13D).[13] For example, when the purpose of such a person's "prospective purchases" (emphasis added) is to gain control, he must disclose his "plans" to liquidate, merge or make any other major change in the issuer's business or structure.[14] Moreover, under Schedule 13D promulgated by the Commission pursuant to Section 13(d),[15] such a person must disclose, in any event, just what the "purpose or purposes of the issuer" is.[16]

Should Schedule 13D, which covers such past, "prospective" and "proposed" purchases, "relate to" a tender offer, request or invitation for tenders, additional information is required.[17] Section 13(d)(1) therefore, requires that the plans and purposes surrounding prospective tender offers be disclosed. In addition, under Schedule 13D persons owning a substantial amount of securities must disclose the fact that their acquisitions are intended to facilitate or defeat possible tender offers by themselves or other persons.

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[13] The subsection applies to persons who beneficially own more than 10 percent of a class before the acquisition as well as to persons who become the beneficial owners of more than 10 percent of the class as a result of the acquisition.

[14] Section 13(d)(1)(C), 15 U.S.C. §78m(d)(1)(C) (Supp. IV, 1969). See **Susquehanna Corp., supra**, Securities Exchange Act Release No. 6933. **Compare Susquehanna Corp. v. Pan American Sulphur Co.**, 423 F.2d 1075 (C.A. 5, 1970).

[15] Section 13(d)(1), 15 U.S.C. § 78m(d)(1) (Supp. IV, 1969), grants the Commission authority to require the disclosure of "such additional information, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors . . ." (emphasis added).

[16] Schedule 13D, Item 4, "Purpose of Transaction."

[17] **Id.**, Item 7, "Persons Retained, Employed or To Be Compensated."

It is clear that if fraudulent disclosures in connection with such future tender offers are held to be beyond the reach of the Williams Act's anti-fraud provisions, the protection afforded to the public by Section 13(d) (1) will be undercut. For example, consider the not uncommon situation where corporations "A" and "B" are both apparently seeking control of target company "T". In the course of laying the groundwork for a tender offer to T stockholders, A acquires more than 10 percent of T's stock and files Schedule 13D pursuant to Section 13 (d) (1) and Regulation 13D thereunder.[18] In order to defeat A's prospective tender offer, B who has also acquired more than 10 percent of T's stock and must therefore file its own Schedule 13D, falsely states therein that it intends to make a tender offer to T shareholders at a better price than A. As a result, as planned by B, the market price of T shares is inflated to prohibitive level and a successful tender offer by A is rendered impossible before it is ever made. B's motive may be to defeat A's prospective tender offer in order to make its own offer possible at some unannounced date when the price of T shares has declined, or B may simply have made its false statement of intent because it entered into a collusive agreement with T's management to defeat A's prospective tender offer.[19] Certainly when Congress

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[18] Among other things, A must thereby disclose: that the "purpose" of his purchases of T stock is to lay the groundwork for a tender offer he intends to make to T shareholders (Schedule 13D, Item 4); such "plans" within the meaning of Section 13 (d) (1) (C) as A may have and finally, that a certain amount of funds is "to be used" to make purchases of T stock (Section 13 (d) (1) (B)).

[19] A collusive agreement to defeat a third party's outstanding tender offer was the subject of litigation under Section 10 (b) and Rule 10b-5 thereunder in **Iroquois Indust., Inc. v. Syracuse China Corp.**, 417 F. 2d 963 (C. A. 2, 1969), **cert. denied**, 399 U.S. 909 (1970) and **Crane v. Westinghouse Air Brake Co.**, 419 F.2d 787 (C.A. 2, 1969), cert. denied, ... U.S. ... (1970).

required the disclosure of the plans and intentions of substantial owners of publicly held companies, it did not intend to exclude fraudulent disclosures of prospective tender offers from the reach of the Act's anti-fraud provision. Such a construction of the Williams Act makes the Act internally inconsistent. Fraudulent statements of intent to make a tender offer made pursuant to Section 13 (d) (1) should be considered, under the terms of Section 14 (e), to be "in connection with any tender offer" and therefore unlawful.

Unlike Section 13 (d) (1), Section 14 (d) of the Williams Act requires that Schedule 13D be filed at the time a tender offer is made and published. However, this provision is not inconsistent with the above interpretation of 13 (d) (1) and the reasons underlying Section 14 (d) are unrelated to a proper interpretation of Section 14 (e).

Congress did not require disclosure under Section 14 (d) when a company first reached an intent to make a tender offer (as opposed to the time the offer was made) because a public announcement of the circumstances surrounding such an intent would create unjustified market expectations particularly since the announcement itself might ultimately prevent the tender offer's consummation by raising the price of the target company's securities.[20] As secrecy was recognized as frequently being important to the success of most takeover bids, it seemed inappropriate to require disclosure at the time a company first intended to make an offer.[21] Such considerations are not relevant

[20] Moreover, the substantive protections under 14 (d) of withdrawal rights, pro rata acceptance, and equal price treatment necessarily presume a tender offer which is ongoing.

[21] An early draft of the Williams legislation, S. 2731, 89th Cong., 1st Sess. (1965), would have required an offeror whose proposed acquisition would result in more than 5% beneficial ownership to inform the target of its intentions twenty days before making the tender offer. The Commission recommended

to the requirement under Section 13 (d) (1) that plans and purposes surrounding a **prospective** tender offer be disclosed. Congress recognized that the acquisition of more than a ten percent interest in a company might well presage a change in control and that the investing public was entitled to know the facts bearing on the desirability of tendering its shares at a particular price. Thus, in this particular situation as distinguished from those covered in Section 14 (d)'s disclosure prior to a contemplated tender offer of the identity and intentions of the persons responsible for such large acquisitions seemed advisable and was required.

In short, the provisions of both Section 13 (d) (1) and 14 (d) of the Williams Act are addressed to the question of **when** the law should **require** that certain information be publicly disclosed. They afford no justification for the view that mere voluntary announcements are made pursuant to a prospective tender offer, such announcements need not comport with the Act's anti-fraud provisions.[22]

that the pre-offer disclosure period be reduced to five days. MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION TO THE COMMITTEE ON BANKING AND CURRENCY, U.S. SENATE ON S. 2731, 112 Cong. Rec. 19083-86 (1966) and the five day provision was incorporated into the House's version of the 1968 legislation, H.R. 14475, 90th Cong., 2nd Sess. (1968). Largely in response to objections that the five day pre-offer notice requirement would result in leaks and market manipulation, see **Hearings on H.R. 10475 before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce**, 90th Cong., 2nd Sess. at 43-47 (1968) and **Hearings on S. 510 Before the Subcommittee on Banking and Currency**, 90th Cong., 1st Sess. at 69-106 (1967), the version of Section 14 (d) which was finally enacted contains no provision for advance notice to the target company and filing is required only at the time the tender offer is first made and published.

[22] As discussed **supra** pp. 11-12, under Section 13 (d) (1) a prospective offeror may be required to state his intentions publicly. **A fortiori**, Section 14 (e) should apply to such announcements whether or not the prospective offeror follows through with his intentions.

Paragraph (8) of Subsection 14 (d) contains certain exemptions from its requirements, but again, for reasons which relate

This interpretation of the anti fraud provision is consistent with other similar situations under the federal securities laws where the antifraud provisions have been held applicable, even though a particular event or transaction is exempt from certain filing requirements.[23]

The fact that secrecy is often crucial to the success of an intended takeover may in part explain why public disclosure is not required under Section 14 (d) until the offer is actually made. An offeror's interest in secrecy, however, does not restrict the use of deliberate fraud which

only to this subsection's particular purposes. There are exemptions, for example, from 14(d) for tender offers proposed to be made by a registration statement and for tender offers by an issuer for the issuer's own securities. Congress believed, in the case of exchange offers of stock, that registration under the Securities Act of 1933 provided adequate disclosure. The exemption for tender offers by an issuer for the issuer's own securities presumably results from the fact that the Commission was given authority under section 13(e)(1) to adopt rules defining fraudulent practices in connection with an issuer's repurchase of its shares. These distinctions are not in the antifraud provision (Section 14(e)) because they are irrelevant to the broad purpose of this section which is to prohibit fraud in connection with tender offers. Thus, Section 14(e) would apply to fraudulent exchange offers of stock, fraudulent tender offers by an issuer for its own securities and fraudulent tender offers which have not yet commenced, although all of these may not be subject to the disclosure provisions of Section 14(d).

[23] Indeed, in the landmark decisions which first recognized the private right of action under Rule 10b-5, it was held that Rule 10b-5 was applicable even though the stock was "not registered on an exchange nor traded in the over-the-counter market, and no security dealer or broker was used in effecting the purchases." **Robinson v. Difford**, 92 F. Supp. 145, 147 (E.D. Pa. 1950), **accord. Kardon v. National Gypsum Co.**, 69 F. Supp. 512, 514 (E.D. Pa., 1946) and 73 F. Supp. 798 (E.D. Pa., 1947). **See also Northern Trust Co. v. Essaness Theatres Corp.**, 103 F. Supp. 954, 959-61 (N.D. Ill., 1952); **Speed v. Transamerica Corp.**, 99 F. Supp. 830-31 (D. Del., 1951); **Pratt v. Robinson**, 303 F. 2d 627 (C.A. 9, 1953), **Matheson v. Armburst**, 284 F.2d 670, 674 (C.A. 9, 1960) certiorari denied, 365 U.S. 870 (1961); Cf. **Securities and Exchange Commission v. National Securities, Inc.**, 393 U.S. 453 (1969).

to may attempt to perpetrate. For example, a company may fraudulently represent that it has no intent to make a tender offer in order to drive the price of the target company's securities down and facilitate a later bid, see **Electronic Specialty Co. v. International Controls Corp.**, supra, 409 F. 2d 937. This later bid may or may not in fact occur depending perhaps on the success of the fraud. It does not appear Congress intended the application of the antifraud provisions to turn on whether in fact the company did make a tender offer after having manipulated the price of the target company's shares.

Indeed, Section 14(e) proscribes "manipulative acts or practices" in connection with any tender offer.[24] In another instance, a target company may falsely state that it intends to make a tender offer to its own shareholders which will be more attractive than an outsider's intended bid. The purpose would be to inflate the price of the target company's own shares and thereby discourage or defeat the threatened offer. Once again, where such a defensive move succeeded in preventing the outsider's takeover bid, it would not seem that Congress would have intended that Section 14(e) not apply because the fraud here was, in fact, successful with result that no tender offer was "actually made."

Plaintiff, in the present case, alleges that Sedco fraudulently held out the promise of an exchange offer, an

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[24] As one writer has observed, Note, **Cash Tender Offers**, 83 Harv. L. Rev. 377, 397 (1970), the majority and dissent in **Electronic Specialty, supra,** both proceeded on the unarticulated assumption that pre-offer conduct can be a violation of Section 14(e), the antifraud provision. Section 14(e)'s 'in connection with' language extends beyond merely post-offer activities. This extension is especially significant in the case of market manipulations, because manipulation is likely to be most attractive before the offer itself. Courts should read generously the 'in connection with' language of Section 14(e) as a ban on manipulations in order not to rob the provision of its broad protective effect." (Footnote omitted.)

nounced its terms, falsely represented that no redemption would take place prior to the termination of the exchange offer, filed a fraudulent registration statement pursuant to the exchange offer and finally, solicited preferred shareholders to accept the proposal before redeeming the preferred shares.[25] Plaintiff alleges defendant thereby artifically inflated the price of the preferred stock, fraudulently induced the preferred shareholders to vote in favor of certain corporate matters and misled them into retaining their preferred holdings. The fact that no exchange offer was "actually made" was part of the fraud which is alleged to have been perpetrated. The Commission believes that such a fraud on the preferred holders was in connection with a tender offer within the intended meaning of Section 14(e). Plaintiff alleged a violation of the section and his complaint should not have been dismissed in this regard.[26]

II. Plaintiff Has Stated a Claim for Relief Under Section 10(b) of the Exchange Act and Rule 10(b)-5 Thereunder.

Although the Commission believes a cause of action under Rules 10b-5 is stated when, as in this case, an individual alleges that misrepresentations have influenced his judgment to buy, sell or hold securities and he has suffered damage thereby,[27] we recognize that this Court has often stated that recovery of damages under Rule 10b-5 is limited to persons who are actual purchasers or sellers of

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[25] Whether there was in fact a solicitation (See Brief of Appellee, p. 36) is irrelevant for purposes of this appeal.

[26] The Commission expresses no views on what might be the appropriate relief or measure of damages flowing from this violation of Section 14(e). Cf. Eahan v. Rosenthal, 424 F.2d 161 (C. A. 3, 1970), cert. denied, 398 U.S. 950 (1970).

[27] See discussion infra pp. 24-25.

the securities involved.[28] Accepting this view for present purposes, nevertheless, we believe plaintiff has stated a claim for relief on the ground that Seilon's redemption of preferred stock resulted in a forced sale of preferred shares in connection with the fraud alleged.

A. Seilon's Redemption Resulted in a "Forced Sale" in Connection with the Fraud Alleged.

The authority relied upon by the court below for its holding that Seilon's redemption did not give rise to a sale was **Securities and Exchange Commission v. Sterling Precision Corp.**, 393 F. 2d 214 (C. A. 2, 1968). **Sterling** held that an affiliate's redemption of its debentures and preferred stock held by the affiliated registered investment company did not constitute a "purchase" within Section 17(a)(2) of the Investment Company Act, 15 U.S.C., § 80a-17(a)(2). Certain purchases by such an affiliate are made unlawful under Section 17(a)(2) and the Commission had cited this prohibition as grounds for an injunction against the affiliate for failing to obtain the Commission's approval under Section 17(b), 15 U.S.C. 80a-17(b). In holding that the affiliate's redemptions did not constitute a Section 17(a)(2) "purchase," this Court looked to the particular dangers which the Investment Company Act sought to remedy. It noted that despite the fact that "Congress was principally concerned with protecting the assets of investment companies from unscrupulous management," Congress nevertheless permitted affiliates "to sell" back an investment company's securities without Commission approval.[29]

Moreover, there was no dispute in **Sterling** that redemptions by the investment company constituted such

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[28] **See e.g., Greenstein v. Paul**, 400 F.2d 580 (C.A. 2, 1968); **Iroquois Industries, Inc. v. Syracuse China Corp., supra.**

[29] **Sterling Precision, supra**, 393 F. 2d at 218.

exempted "sales" within the meaning of the Act. Thus, this Court reasoned that "if Congress believed that redemptions of this type [i.e. by an investment company] could safely be left unsupervised, it follows a fortiori that redemptions by 'affiliates' . . . should also be."[30] The court concluded that any danger presented to the investment company by an affiliate's redemptions "was not one of the principal evils the Act sought to remedy."[31]

In short, Sterling rests on an interpretation of the purpose of Section 17(a)(2) of the Investment Company Act[32] and should not, therefore, determine the scope of "sale" as used in an anti-fraud provision of the Securities Exchange Act, a provision designed to serve different objectives. The Supreme Court has cautioned that various sections of the securities laws must be interpreted in their

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[30] Id.

[31] Id. at 219. The court also relied upon the fact that Congress used the terms "redemption" and "purchase" separately in the Investment Company Act.

[32] The court below apparently overlooked this fact. In reasoning fr n the holding in Sterling, Judge McLean said, "If a corporation which redeems its preferred stock does not thereby 'purchase' it, it would seem to follow that the stockholder who delivers it for redemption does not 'sell' it" (42a). Actually, Sterling only held that redemptions by corporations who are affiliates of investment companies are not "purchasers" within the Investment Company Act. Everyone agreed that when it was the investment company that redeemed instead of the affiliate, a "sale" of stock resulted. The presence, in the context of a redemption, of a "sale" on the one hand, but "no purchase" on the other, depended on whether it was the investment company or the affiliate that was redeeming. This, in turn, resulted from the statutory scheme and the court's interpretation of it in Sterling.

The court below also referred to the reasoning in Sterling that words should be given their normal meaning (42a), but this would seem to have more force in construing the Investment Company Act where "purchase" is left undefined, than in interpreting the meaning of "sale" as defined by Congress in the Exchange Act.

own contexts.[33] Whereas Congress left "purchase" undefined in the Investment Company Act, it spoke directly to the meaning of both "purchase" and "sale" as used in the Exchange Act. Congress said that unless the context otherwise requires, a "purchase" under the Exchange Act includes "any contract to buy, purchase or **otherwise acquire**" and a "sale" includes "any contract to sell or **otherwise dispose of**." (Emphasis added.) As "has been pointed out . . . the verb 'includes,' rather than the verb 'means,' emphasizes the breadth of this definition . . . and the phrases 'or otherwise acquire' and 'or otherwise dispose of' are hardly limiting."[34] While the Supreme Court recently noted that this language indicates the breadth of the statutory terms, it stated that in determining whether alleged conduct is "in connection with the purchase or sale of any security," the question to be asked is whether the conduct is "the type of fraudulent behavior which was meant to be forbidden by the statute and rule"—not merely whether what occurred fits literally within the statutory definitions.[35]

The context of Section 10(b) does not "otherwise require" this Court to depart from the broad concepts of "purchase" and "sale" adopted by Congress in the Exchange Act. Indeed, it is fundamental that the Exchange

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[33] "[B]oth the 1933 and 1934 Acts preface their lists of general definitions with the phrase 'unless the context otherwise requires' . . . We must therefore address ourselves to the meaning of the words 'purchase or sale' in the context of Sec. 10(b). Whatever these or similar words may mean in the numerous other contexts in which they appear in the securities laws, only this one narrow question is presented here." **Securities and Exchange Commission v. National Securities, Inc.**, 393 U.S. 453, 466 (1969).

[34] **Vine v. Beneficial Finance Co.**, 374 F.2d 627, 634 (C.A. 2, 1967), **certiorari denied**, 389 U.S. 970 (1967).

[35] **Securities and Exchange Commission v. National Securities, Inc.**, **supra** at 467.

Act must be construed broadly to effectuate its remedial purpose.[36] When through an acquisition or disposition of securities a person may be defrauded, a "purchase" and "sale" has occurred within the intended meaning of Section 10(b). Because a redemption involves a surrender of securities for cash, as a practical matter, the exercise of a redemption right may occur under circumstances which have the effect of defrauding shareholders. For example, if fraudulent representations concerning a possible redemption affect the judgment of investors so that they retain their securities and are thereby forced to accept a redemption price instead of a higher amount which would have been otherwise available, these persons have a claim as "forced sellers" under Section 10(b) and Rule 10b-5 for resulting damages. There is little reason to distinguish a redemption from a forced sale under the short form merger statutes,[37] a forced sale as part of a corporate liquidation[38] or a forced sale under threat of divestiture for possible anti-trust violations.[39] In each situation the stockholders' rights are frozen and "as a practical matter," he is forced to accept cash for his stock. Thus, he "must eventually become a party to a 'sale' as that term has always been used."[40]

Prior to the announced redemption, in the instant case plaintiff had the option of selling the preferred shares at a higher price on the market. However, he was misled into retaining his shares on the basis of the false repre-

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[36] **Teherepnin v. Knight**, note 11 **supra**.

[37] **Vine v. Beneficial Finance Co.**, note 34 **supra**.

[38] **Coffee v. Permian Corp.**, No. 29093 (C.A. 5, November 23, 1970).

[39] **Crane v. Westinghouse Air Brake Co.**, 419 F.2d 787 (C.A. 2, 1969), **certiorari denied**, ... U.S. ... (1970).

[40] **Vine v. Beneficial Finance Co.**, note 34 **supra**, at 634.

sentation that his shares would **not** be redeemed prior to the expiration of the exchange offer. Once that offer was withdrawn and the redemption announced, he was "forced" to offer the shares in redemption.

Alternatively, the court below held that even if the redemption gave rise to a "sale" within the statute and rule, the alleged fraud was not "in connection with" this redemption (43a). The court explained:

> "The essential fraud is the representation that defendant would exchange common stock for preferred. (Footnote omitted.) It is because defendant failed to do this that plaintiff allegedly sustained injury. Defendant had the right under its charter to redeem its preferred stock for cash, as it eventually did" (43a).

Thus, the court apparently held that since the fraud alleged contributed nothing to the corporation's power to redeem, the fraud was not "in connection with" that redemption. We believe the court misconstrued plaintiff's complaint. That Seilon may always have had a corporate right of redemption is no answer to the contention that it exercised this right fraudulently or that apart from such fraud, it could not have raised the money necessary to redeem.[41]

In order to recover damages under Section 10(b) and Rule 10b-5 a plaintiff must prove that misstatements in connection with a purchase or sale of a security in fact caused him to suffer injury. **List v. Fashion Park, Inc.**, 340 F.2d 457, 463 (C.A. 2, 1965), **certiorari denied sub nom., List v. Lerner**, 382 U.S. 811 (1965).[42] In this case plaintiff alleged that a fraudulent scheme involving a redemption

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[41] This latter contention appears to be implicit in the complaint.

[42] "What must be shown is that there was deception which misled Class A stockholders and that this was in fact the cause of plaintiff's claimed injury." **Vine v. Beneficial Finance Co.**, note 34 supra, at 635.

caused him injury.[42] The lower court held no claim had been stated because Seilon always **could have** redeemed its preferred shares and that therefore the alleged fraud was not "in connection with" such redemption (43a). In so holding, the court failed to recognize that plaintiff alleges Seilon's redemption was fraudulent because the redemption had occurred under false pretenses. That is, plaintiff alleges that Seilon had intended to redeem when it repeatedly assured the public and its preferred stockholders that it would not (28a; 30a-31a).

Thus, fraudulent misstatements not only were "in connection with" the redemption, they were an integral part of it. Certainly Seilon could have acted otherwise than alleged. Perhaps, it could have used its power to redeem without misleading the preferred shareholders. The fact is that for purposes of this appeal[44] it did not, and plaintiff alleges he thereby suffered damages. Whether a redemption untainted by fraud would have occurred in any case and caused the same injury to plaintiff, is not ascertainable from the pleadings at issue.

> "Defendants cannot accomplish by deception what they might have accomplished honestly and then be heard to say that the deception was not the cause. Lawsuits are determined by what was and not what might have been."[45]

[42] A single scheme which includes all of Seilon's fraudulent activities is alleged in § 21 of the amended complaint. Paragraph 25 states: "But for frauds culminating in the redemption acquisition, the plaintiff and all other members of the class would have accepted the Invitation for Tenders and would have tendered their preferred shares."

[44] The complaint must be taken as true and any ambiguities resolved in favor of the plaintiff. **A. T. Brod & Co. v. Perlow**, 375 F.2d 393, 397 (C.A. 2, 1967).

[45] **Eagle v. Horvath**, 241 F. Supp. 341, 343 (S.D.N.Y., 1965); **Swanson v. American Consumer Industries, Inc.**, 415 F. 2d 1326, 1331-32 (C.A. 7, 1969); **Laurenzano v. Einbender**, 264 F. Supp. 356 (E.D.N.Y. 1966); **see also Rosenblatt v. Northwest Airlines, Inc.**, No. 35602 (C.A. 2, December 3, 1970).

Of course appellant may not be able to prove his alleged damages by showing, for example, that but for Seilon's fraudulent scheme there would have been an exchange offer which he would have accepted. In the Commission's view, this is a matter which need not and should not be determined summarily on a motion to dismiss.[46]

B. Plaintiff Has a Claim for Relief Under Section 10(b) and Rule 10b-5 Since He Alleges That Misrepresentations Affected His Investment Judgment and He Suffered Damages Thereby.

Although the Commission believes plaintiff has standing under Section 10(b) as set forth **supra**, the Commission urges the Court not to rely upon this circumstance. There should be a remedy for all persons who have been proximately injured by a violation of an antifraud provisions.[47] Those who are fraudulently induced to retain securities and are injured thereby are no less deserving than other victims of manipulative or deceptive devices who happen to be purchasers or sellers. Assuming the truth of plaintiff's allegation, Seilon clearly violated Section 10(b) and Rule 10b-5, and but for the analysis set forth **supra**, he lacks standing under the traditional analysis to seek damages for the injury suffered because he has not made a completed purchase or sale of securities. This principle was first enunciated in this Court's opinion in **Birnbaum v. Newport Steel Corp.**, 193 F. 2d 461, **certiorari denied**, 343 U.S. 956 (1952). This so-called "purchaser-seller" requirement has been the subject of nu-

[46] See **Schoenbaum v. Firstbrook**, 405 F.2d 215, **218 (en banc** C.A. 2, 1968), **certiorari denied sub nom., Manley v. Schoenbaum**, 395 U.S. 906 (1969).

[47] See **Fischman v. Raytheon Mfg. Co.**, 188 F. 2d 783 (C.A. 2, 1951). Private rights of action are "a necessary supplement" to the Commission's own enforcement activities, **J. I. Case Co. v. Borak**, 377 U.S. 426, 432 (1964); **Mills v. Electric Autolite Co.**, 396 U.S. 375 (1970).

merous decisions of this Court[48] and other courts of appeals[49] and was briefly adverted by the Supreme Court in its decision in **Securities and Exchange Commission v. National Securities, Inc.**, 393 U.S. 453, 467, n. 9 (1969). Indeed, we recognize that this Court has recently stated, in **Superintendent of Insurance, supra**, 430 F. 2d at 359, n. 8, that

> "nothing in the cited cases undermines the now well-settled purchaser-seller rule of **Birnbaum**, especially in view of its recent reaffirmation in **Greenstein** [**v. Paul**, 400 F. 2d 580 (C.A. 2, 1968)]."

Further, the Commission recognizes that the substance of this argument was urged by the Commission in **Iroquois, supra**, and rejected by this Court. However, it appears that much of this argument was adopted by this Court in **Crane, supra**, which the Court of Appeals for the Third Circuit recently stated

> "makes it clear that there is no longer a **per se** requirement that plaintiffs in a 10(b) suit be defrauded purchasers or sellers. In **Crane**, a unanimous panel, including Chief Judge Lumbard who joined in the **Iroquois** decision, held that an action for injunctive relief could be brought by one who was not a purchaser or seller provided there was a casual connec-

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[48] Among the most recent decisions of this Court discussing this so-called test are **Superintendent of Insurance v. Bankers Life and Casualty**, 430 F. 2d 355 (1970), **petition for writ of certiorari filed**, 39 U.S.L.W. 3287 (U.S. Jan. 5, 1971) (No. 25); **Crane Co. v. Westinghouse Air Brake Co., supra**, 419 F. 2d 787; and **Iroquois Industries, Inc. v. Syracuse China Corp.**, 417 F. 2d 963 (1969), **certiorari denied**, 399 U.S. 909 (1970).

[49] Among the more recent decisions of other courts of appeals are: **Herpich v. Wallace**, 430 F. 2d 792 (C.A. 5, 1970), **petition for certiorari filed**, Supreme Court No. 1078; and **Kahan v. Rosenstiel**, 424 F. 2d 161 (C.A. 3, 1970), **certiorari denied**, 398 U.S. 950 (1970).

tion between the alleged violation of 10b-5 and the injury suffered by plaintiff."[50]

While the two cases can be distinguished on the ground that **Iroquois** was an action for damages and **Crane** was an action for injunctive relief, we believe that distinction to be unsound.[51]

We believe that the purchaser-seller requirement is neither compelled nor contemplated by the statutory language; that it is inconsistent with the statutory purpose, and that the decisions upholding this requirement weaken the enforcement of the Act by denying relief to persons who are within the class Congress intended to protect. Accordingly we urge that it not be adhered to. The expansion of the category of persons who may be considered "purchasers" or "sellers" as discussed **supra**, we also believe to be unsound. While one of the purposes of the purchaser-seller rule may have been to eliminate or discourage unnecessary or unsound litigation, we believe the result has been the opposite and has only served to further unnecessary and unwarranted motions and appeals.[52]

The Supreme Court has emphasized that the securities laws are to be construed "not technically and restrictively,

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[50] **Kahan, supra**, 424 F. 2d at 171.

[51] As the court of appeals noted in **Kahan, supra**, 424 F. 2d at 174, n. 14, **"In Asphatic Enterprises, Inc. v. Baldwin-Lima-Hamilton Corp.**, 39 F.R.D. 574, 576 (E.D. Pa., 1966), Judge John Lord stated that 'it is well established that the prayer for relief does not determine whether the plaintiff has stated a cause of action.'" **See also Truth Seeker Co. v. Durning**, 147 F. 2d 54, 56 (C.A. 2, 1945); **Dudley v. Zappa**, 24 F.R.D. 427 (S.D. N.Y., 1959); **Sarlie v. E. L. Bruce Co.**, 265 F. Supp. 371, 377 (S. D. N.Y., 1967). Indeed this Court in **Crane** recognized that one of plaintiff's remedies upon remand might include damages. 419 F. 2d at 803.

[52] **See e.g.**, the litigation: **Greenstein v. Paul, supra**, and **Greenstein v. Lebensfeld** (S.D. N.Y., March 3, 1970, now on appeal C.A. 2, No. 35384).

but flexibly to effectuate [their] remedial purposes." **Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.**, 375 U.S. 180, 195; see **Tcherepnin v. Knight**, 389 U.S. 332, 336. Contrary to that principle, the purchaser-seller limitation adopts a restrictive test of standing which, as this Court has earlier recognized, is not "specifically required" by the statutory language.[53] Section 10(b) and Rule 10b-5 prohibit fraudulent conduct "in connection with the purchase or sale or any security." Nothing in this language limits standing to persons who have succeeded in becoming actual purchasers or sellers. These provisions, which define certain conduct as being unlawful, do not even purport to deal with the question of standing—a question which depends instead on the underlying Congressional purpose. In determining who has standing, i.e., whether the plaintiff is within the class of persons the statute was meant to protect, "a court's quest must be for what will best accomplish the purposes of the legislature." **Electronic Specialty Co. v. International Controls Corp.**, 409 F. 2d 937, 946 (C.A. 2, 1969).

The purpose of the Securities Exchange Act, as its title declares, was "[t]o provide for the regulation of securities exchanges and of over-the-counter markets . . . [and] to prevent inequitable and unfair practices on such exchanges and markets . . ." 48 Stat. 881. Congress intended, as stated in Section 2 of the Act, 15 U.S.C. 78b, "to provide for regulation and control" of "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets" and also of "practices and matters related thereto," and "to impose requirements necessary to make such regulation and control reasonably complete and effective," in order to insure the maintenance of fair and honest markets in such transactions." Consistent

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[53] Mutual Shares Corp. v. Genesco, Inc., 394 F.2d 540, 543 (C.A. 2, 1967).

with the Congressional expression of intent, the courts have emphasized that the Act was designed to "keep the channels of interstate commerce, the mail, and national security exchanges pure from fraudulent schemes, tricks, devices, and all forms of manipulation";[54] "eliminate deceptive and unfair practices in security trading";[55] and "protect the investing public," "promote free and open public securities markets" and "secure fair dealing in the securities markets."[56]

In light of the broadly remedial statutory purpose, persons who participate in the securities markets or in the securities trading processes are entitled to expect that the Act will provide them with an honest market place in which to do business. Participants who, as a result of fraudulent market activities, are prevented from engaging in securities transactions are no less entitled to the Act's protection than are those who are fraudulently induced to enter into such transactions. Indeed, it would be anomalous to hold that a violator who has successfully executed a fraudulent scheme that was designed to prevent the consummation of a purchase or sale (as alleged here) shall, because of his very success, be immune from liability to the aborted purchaser or seller whom he has intentionally injured. Yet that is precisely the effect of the holding of the court below.

An acceptance of the **Birnbaum** purchaser-seller doctrine we submit, is based on a misunderstanding of Rule 10b-5's purpose. Prior to the adoption of Rule 10b-5, although

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[54] **Hooper v. Mountain States Sec. Corp.**, 282 F. 2d 195, 202 (C.A. 5, 1960), **certiorari denied**, 365 U.S. 814 (1961).

[55] **Kahan v. Rosenstiel, supra**, 424 F. 2d 161.

[56] **Securities and Exchange Commission v. Texas Gulf Sulphur Co.**, 401 F. 2d 833, 858, 860 (C.A. 2, 1968), **certiorari denied**, 394 U.S. 976 (1969). See also **A. T. Brod & Co. v. Perlow**, 375 F. 2d 393, 397 (C.A. 2, 1967).

Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), prohibited fraud which was committed in the "sale" of securities (i.e., fraud on purchasers), there was no general prohibition in the federal securities laws against fraud committed in the "purchase" of securities (i.e., fraud on sellers). One of the purposes of Rule 10b-5, as the Commission pointed out in its release accompanying the adoption of the rule, was to close that loophole by making it unlawful to commit fraud both in the purchase and in the sale of securities.[57] The court in **Birnbaum**, however, erroneously believed that the closing of that loophole was the "only" purpose of Rule 10b-5. 193 F. 2d at 463. On the basis of that premise, the court reached two conclusions: that Rule 10b-5 was "directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities" and that Rule 10b-5 "extended protection only to the defrauded purchaser or seller." 193 F. 2d at 464. Neither of those conclusions, it should be noted, was essential to the result reached in the case; the court could have based its denial of relief simply on the ground that there was no indication of any causal connection between the alleged violation of Rule 10b-5 and the plaintiffs' injury.[58]

In **Birnbaum** it was alleged that a corporation's controlling shareholder, after having rejected a favorable merger proposal by another company, sold his controlling block of stock to a group of customers of his own corporation at a premium that represented the power to use the corporation as a "captive" source of supply for the customer group. It was also alleged that certain misrepresentations had been made to the shareholders of the cor-

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[57] See Securities Exchange Act Release No. 3230 (May 21, 1942).

[58] **Crane Co. v. Westinghouse Air Brake Co.**, supra, 419 F. 2d at 797.

poration at the time of the rejected merger and after the later stock sale. The plaintiffs were shareholders of the corporation, seeking relief (presumably damages) on behalf of themselves and on behalf of the corporation. The alleged violation of Rule 10b-5 consisted of the making of the misrepresentations. The injury to the corporation and its shareholders, however, appears to have resulted not from the misrepresentations but from the sale of stock by the controlling shareholder.

That the statements made by the court in **Birnbaum** were not entirely correct was recognized in **A. T. Brod & Co. v. Perlow, supra**, 375 F. 2d at 396, where this Court expressly rejected the **Birnbaum** conclusion that Rule 10b-5 applies only to the type of fraud that is "usually associated with the sale or purchase of securities." Subsequently, in **Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra**, this Court went further and rejected **Birnbaum's** underlying premise as to Rule 10b-5's purpose. The court discussed the Exchange Act's legislative history, which showed that Section 10(b) was intended to secure honest securities markets. 401 F. 2d at 858-859. The court also pointed out that, unlike the anti-fraud provision in Section 17(a) of the 1933 Act which applies to fraud committed "in" securities transactions, Section 10(b) applies more broadly to fraud committed "in connection with" such transactions. **Id.** at 860. Finally, the court concluded that the Commission, in adopting Rule 10b-5, intended "fully to implement the Congressional purpose and objectives underlying Section 10(b)" and accordingly that Rule 10b-5 was intended to accomplish more than just the limited purpose of closing the loophole referred to in the Commission release which accompanied the rule's adoption. **Ibid.** Thus, more recent decisions reaffirming the **Birnbaum** purchaser-seller doctrine have been based on ideas that this Court has rejected in other cases.

The error which the court made in **Birnbaum** resulted from a failure fully to appreciate the role occupied by Rule 10b-5 in the statutory scheme of investor protection. The court viewed Rule 10b-5 as dealing with the ordinary face-to-face situation in which A makes misrepresentations to B, who in reliance thereon enters into a securities transaction. Although even in 1952, when the court decided **Birnbaum**, Rule 10b-5 had been applied in other contexts, only in more recent years has the broad coverage of the rule come to be fully recognized. Insofar as private actions are concerned, today Rule 10b-5 may well be the single most important provision through which relief may be obtained under the federal securities laws; and both in private actions and in the Commission's own enforcement activities, Rule 10b-5 is one of the key provisions for maintaining the integrity of the securities markets. Of particular significance, for present purposes, is the rule's applicability to situations in which whole classes of persons are deceived - for example, the dissemination of fraudulent press releases affecting the entire market place,[59] the use of false representations to obtain shareholder consent to mergers,[60] and the making of fraudulent tender offers.[61] In certain of these situations it is possible, by deceiving a sufficiently large number of people, to injure a person who has not himself relied on the misrepresentations and has therefore not been deceived. In recognition of this factor, it has been held that the injured person in such a situation has standing to obtain damages under Rule 10b-5 notwithstanding his failure to satisfy

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[59] See **Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra; Heit v. Weitzen**, 402 F. 2d 909 (C. A. 2, 1968), **certiorari denied**, 395 U. S. 903 (1969).

[60] See **Securities and Exchange Commission v. National Securities, Inc., supra.**

[61] **See Vine v. Beneficial Finance Co., supra; Crane Co. v. Westinghouse Air Brake Co., supra; Kahan v. Rosenstiel, supra.**

the traditional requirement that reliance be established in order to recover for fraud.[62] Thus, Rule 10b-5 does not, as the court in **Birnbaum** believed, deal only with a simple face to face transaction in which B relies upon A's misrepresentation. Rule 10b-5 is considerably broader in scope. And in view of this broad scope, the purchaser-seller limitation is an anachronism which conflicts with the present day need of investor protection.

Dissatisfied with the purchaser-seller limitation but unwilling to abandon it completely, the courts have tried to find ways of avoiding its impact. For example, this Circuit and the Third and Sixth Circuits have held that a person who is neither a purchaser nor a seller may maintain an action under Rule 10b-5 when the relief sought is an injunction against a continuing violation rather than damages.[63] At times, these efforts to avoid the effect of **Birnbaum** have resulted in somewhat strained reasoning and even in meaningless distinctions.[64] We submit that, instead of continuing this confused situation, the proper course of action is to reject the purchaser-seller limitation. The Supreme Court has stated that Rule 10b-5 is "an area where glib generalizations and unthinking abstractions are major occupational hazards."[65] The purchaser-seller limitation fits that description perfectly.

The Commission believes the proper view is that a claim under Section 10(b) and Rule 10b-5 is stated when an individual alleges that misrepresentations have influenced

[62] **Vine v. Beneficial Finance Co., supra; Crane Co. v. Westinghouse Air Brake Co., supra.**

[63] **Mutual Shares Corp. v. Genesco, Inc., supra; Kahan v. Rosenstiel, supra; Britt v. Cyril Bath Co.**, 417 F. 2d 433 (6 A. 6, 1969).

[64] See **Kahan v. Rosenstiel, supra; Crane Co. v. Westinghouse Air Brake Co., supra.**

[65] **Securities and Exchange Commission v. National Securities, Inc., supra,** 393 U.S. at 465.

his judgment to buy, sell or hold securities and he has suffered damages thereby. Several cases, in fact, have indicated that a claim under Rule 10b-5 may lie, even absent a purchase or sale of a security, provided that the individual to whom such misrepresentations were made alleges that he was thereby induced to retain securities which he might otherwise have sold. **Stockwell v. Reynolds & Co.**, 252 F. Supp. 215 (S.D.N.Y., 1965) held that a claim for damages under Rule 10b-5 would lie where misrepresentations induced customers of a broker-dealer not to sell their securities. In that case the court stated with respect to the "in connection with" language that "[t]he words have been construed more liberally in order to carry out the intent of the Act, which is designed **to protect investors** against fraud" (emphasis added) **id.** at 219. **Hanly v. Securities and Exchange Commission**, 415 F.2d 589 (C.A. 2, 1969) held that a broker-dealer who had said that certain stock was "worth holding" had violated the rule even though the individual to whom the representations were made merely continued to hold his stock and did not sell or purchase any shares. The view that misrepresentations or omissions of material fact which induce a shareholder to hold his securities are within the purview of Rule 10b-5 is also implicit in the definition of "materiality" adopted in **Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra**, 401 F. 2d at 849; material facts include those "which may affect the desire of investors to buy, sell or hold the company's securities." (Emphasis added.) Cf. **Rekant v. Desser, supra**, 425 F.2d at 879.

It has been suggested that the motive for adhering to the purchaser-seller requirement has been that the requirement serves a useful function by limiting liability under the expansive language of Rule 10b-5.[66] To the extent

[66] **Mutual Shares Corp. v. Genesco, Inc., supra**, 384 F. 2d at 543; **Rekant v. Desser**, 425 F. 2d 872, 877 (C.A. 5, 1970).

that it serves this function, however, it does so in a purely fortuitous fashion that often produces unjust results. Thus, although on occasion the purchaser-seller requirement may operate to deny standing to a person who, for some reason, properly should be refused relief under Rule 10b-5, the requirement can just as frequently operate to deny standing to a person who should be afforded relief.

Since the purchaser-seller requirement thus operates in a fortuitous manner which often is unrelated to the statutory purpose, we believe that it should be rejected. There need be no fear, however, that Rule 10b-5 would then function without any limitations so as to impose unwarranted liability. There are various limitations—apart from the purchaser-seller requirement—which the courts can and do apply in a manner which is in accord with the statutory purpose. For example, a plaintiff cannot recover damages under Rule 10b-5 unless (1) the fraud related to a material matter,[67] (2) there was a casual connection between the alleged violation and the plaintiff's claimed loss,[68] and (3) a loss has, in fact, been sustained.[69] And the plaintiff must, of course, establish his damages with sufficient certainty to warrant recovery.[70] It should be noted that this case does not involve the question of whether damage liability for misrepresentations affecting large numbers of investors should be imposed in the absence of scienter. See **Heit v. Weitzen, supra**, 402 F. 2d at 913-914, 917; **Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra**, 401 F. 2d at 866-868 (con-

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[67] **List v. Fashion Park, Inc.**, 340 F. 2d 457, 462, 464 (C.A. 2, 1965), certiorari denied, 382 U.S. 811.

[68] **Kahan v. Rosenstiel, supra**, at 172-73; **Mutual Shares Corp. v. Genesco, Inc., supra**, 384 F. 2d at 546-547.

[69] **Mutual Shares Corp. v. Genesco, Inc., supra**, 384 F. 2d at 546-547.

[70] Harper and James, **The Law of Torts** (1956), pp. 1304-1307.

curring opinion of Judge Friendly). The complaint specifically alleges that respondents knew of the falsity of their representations to the preferred shareholders and that they made those representations for the purpose of misleading the preferred shareholders.

CONCLUSION

For the foregoing reasons the complaint should not have been dismissed and the decision of the district court should be reversed.

Respectfully submitted

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